

1993

Guide to depositing and reporting income taxes withheld under the new mandatory 20 percent withholding rules

American Institute of Certified Public Accountants. Federal Taxation Division

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American Institute of Certified Public Accountants. Federal Taxation Division, "Guide to depositing and reporting income taxes withheld under the new mandatory 20 percent withholding rules" (1993). *Association Sections, Divisions, Boards, Teams*. 75.
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Guide to Depositing and Reporting Income Taxes Withheld Under the New Mandatory 20 Percent Withholding Rules

Tax Division

MARCH 1993

AICPA

American Institute of Certified Public Accountants

1455 Pennsylvania Avenue, N.W., Washington, D.C. 20004-1081

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Tax practice guides are designed as educational and reference material for the members of the Tax Division and others interested in the subject. They do not establish standards or preferred practices.

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PURPOSE

The primary purpose of this Withholding and Deposit Guide for Qualified Plans (Guide) is to assist practitioners in dealing with certain tax problems that arise for qualified plans required to withhold income taxes under the new mandatory withholding provisions of the Unemployment Compensation Amendments Act of 1992. This Guide also includes references to rules affecting elective withholdings from qualified plan documents and the general deposit rules for tax withholding. The Guide is designed as educational and reference material for members of the AICPA Tax Division and others interested in the subject. It is distributed with the understanding that the AICPA Tax Division is not rendering any tax or legal advice.

PREFACE

Tax practice requires a working knowledge of tax laws and existing federal tax reference material. The Guide is intended to provide information that is current and accurate. It is not presently intended that the AICPA Tax Division will update this guide as routine changes are made in either the Internal Revenue Code or Treasury Regulations. As such, users of the Guide should review all references to ensure that any subsequent statutory changes, interpretations, guidance, or court decisions are considered in light of the advice being rendered to their clients. Nevertheless, comments, questions, and suggestions are welcome. In the event this publication is updated, such comments would be invaluable in making the product better for all members of the Tax Division.

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GUIDE TO DEPOSITING AND REPORTING INCOME TAXES WITHHELD UNDER THE NEW MANDATORY 20 PERCENT WITHHOLDING RULES

I. OVERVIEW

The Unemployment Compensation Amendments Act of 1992 added the requirement of a mandatory 20 percent withholding for most qualified plan distributions which are not directly rolled over into a successor plan or IRA. This mandatory withholding will mean new or added reporting and deposit requirements for many plans which heretofore had little or no withholding from the distributions they made each year. This change in the withholding requirement, coupled with changes in the deposit timing rules, both of which took effect January 1, 1993, will take many plans off-guard.

The basic framework for reporting and depositing retirement plan withholdings has not changed from that laid out under the elective withholding regulations. However, there will be a significant increase in the dollar volume, and in the number of plans needing to file either Form 941 or Form 941E reports and make advance deposits of the amounts withheld. The Form 941 is used to report withholdings of Social Security, Medicare and income tax, while the Form 941E is used only for income tax and some Medicare withholdings. This is outlined further in Section IV.

In addition, practitioners are advised to reconfirm state and local withholding rules to determine if the federal changes will necessitate a change at these other levels for their practice location.

II. OPTIONS FOR COMPLIANCE

A. Shifting the Obligation

A plan administrator has the option to shift the obligation for withholding, making deposits of the withholdings and reporting the withholdings to the payor of the distribution (section 31.3405(c)-1T Q&A 4 and Q&A 11). A plan administrator accomplishes this by: (1) directing the payor in writing to withhold the tax and (2) providing the payor with sufficient information to accomplish the withholding (section 35.3405-1 Q&A E2). This transfer would remain in effect until the plan administrator chose to revoke it in writing. This option allows a plan administrator whose plan investments are with a bank, an insurance company, or an investment company to potentially transfer the obligation of withholding and reporting if that institution is paying out the distributions to the distributee. The payor should acknowledge their acceptance of the withholding and reporting obligation. The plan administrator must provide the payor with adequate information to allow it to fulfill

the obligations under the law. At a minimum, the payor must know (section 35.3405.1 Q&A E3):

1. The name, address, and social security number of the payee, and the payee's spouse or other beneficiary, if applicable.
2. The amount of the distribution, including information regarding the portions which are includible in gross income.
3. A statement of the reason for the payment or distribution.
4. The amount and frequency of payment and commencement date for the distribution.
5. The age of distributee and spouse or beneficiary, if applicable.
6. Any other information required by Form 1099-R.

B. Alternative Reporting and Deposit Administration

Payors and plan administrators have three options to consider for purposes of the entity that will deposit and report the withholding. The mandatory withholding regulations reaffirm in the explanatory portion that the deposits of amounts withheld should be done in accordance with Internal Revenue Code section 6302 and may make use of the alternatives described in IRS Announcement 84-40. Announcement 84-40 outlines the following three options:

1. Each qualified plan may request an Employer Identification Number (EIN), using a Form SS-4 for its trust if it does not already possess one. The plan administrator would then make deposits under the plan's Employer Identification Number and file the appropriate form, either 941 or 941E to report the withholdings for the plan. This option is recommended as the preferred method.
2. A payor or plan administrator who controls or is responsible for numerous plans (including Keoghs, IRAs and SEPs) can apply for an EIN solely for the purpose of depositing and reporting the total withholding from the distributions of all its plans and file either a Form 941 or Form 941E as appropriate.
3. An employer, plan sponsor, payor or plan administrator may aggregate the withholding on plan distributions with the amounts to be deposited for its own employees. The amounts withheld would then be reported on the same tax return. The qualified plan distribution is not included in wages paid on either

the Form 941 or Form 941E. Only the amount of income tax withheld from the distributions is shown on the return on Line 3.

While the three options exist, plan administrators and employers concerned about tracking and accounting for withholdings, and minimizing possible confusion at the Internal Revenue Service with deposit liabilities, will most likely choose Option 1 listed above. Employers who utilize outside payroll services may find their payroll service provider uncooperative about including plan distribution withholdings on the employer's Form 941 wage reports. Additionally, Option 1 is preferable if there is any concern about tax liens on the employer. This is an issue since the trust/plan withholdings under Option 3 would be contained in the general account of the employer. It is likely that Option 3 above, employers combining the plan's withholding with their own, will be the second most utilized alternative. Banks and other payors combining the withholdings of their customer's plans may prove to be the least preferred option.

III. DEPOSIT RULES

A. Categories of Tax Depositors

Under the new tax deposit regulations (section 31.6302-0), a payor or an administrator will fall under one of two main categories and possibly one of two sub-categories. This determination has to be made taking into consideration any decision under the options above to shift or aggregate withholdings.

1. A payor or plan administrator with less than \$500 in withholding taxes during a quarter, can remit the withholdings with either the Form 941 or Form 941E.
2. If a payor's or administrator's total reported employment taxes (including qualified plan withholdings) are \$50,000 or less during the look-back period, they are a monthly depositor of their withholdings.
3. A payor or plan administrator whose employment tax liability (which includes income tax withholdings) is more than \$50,000 during the look-back period is a semi-weekly depositor. This includes income tax withholdings on qualified plan distributions.
4. Any payor or plan administrator that accumulates employment taxes of \$100,000 or more during any deposit period will be required to deposit the taxes on the first banking day after the \$100,000 limit is reached.

B. Determination of Deposit Status

In general, a plan or payor's deposit status is determined on the basis of the look-back period. The look-back period for any calendar year is the preceding July 1 to June 30. This determination must be made each year. In 1993, a payor or plan administrator who has no previous employment tax liability would come under the monthly rules for their first year. Subsequent status would depend on the actual liability level during the future determination periods. At any time a monthly depositor meets the \$100,000 one day rule, they immediately lose their monthly status and become semi-weekly depositors for the remainder of the calendar year and for the following calendar year. In this instance, the change would not wait for the annual redetermination.

C. Method and Timing of Deposits

Payors and plan administrators who meet one of the advance deposit thresholds outlined above will need to make a deposit using Federal Tax Deposit (FTD) coupons (Form 8109). The deposit should be made to a Federal Reserve Bank or authorized financial institution in the same manner as other deposits of employment taxes.

1. Monthly depositors are required to deposit all withholdings from the previous month by the 15th of the following month.
2. The timing for semi-weekly depositors is dependent upon the date the distributions are paid.
 - a) Payments made on Wednesday, Thursday, or Friday are due on or before the following Wednesday.
 - b) Payments made on Saturday, Sunday, Monday, or Tuesday are due on or before the following Friday.
3. Any payor or plan administrator who accumulates more than \$100,000 in withholdings on any day of their deposit period (monthly or semi-weekly) must deposit those taxes by the end of the next banking day.

D. Obtaining Federal Deposit Coupons

It is preferable to use pre-printed Federal Tax Deposit (FTD) coupons which have the appropriate Employer Identification Number (EIN). The EIN will depend upon the option selected under Section II above. Most employers, upon application for an EIN, automatically receive a coupon booklet. Qualified plans that apply for an EIN as a trust have not automatically received coupon books in the past. If a payor

or plan administrator needs coupons, they can contact a local IRS office and request them. If a deposit must be made prior to the receipt of the preprinted coupons, the administrator or payee can obtain a blank FTD coupon (Form 8109). Care should be taken to complete the required information, including the correct EIN, before depositing. Use of non-preprinted coupons has been shown to increase the probability of error in processing.

IV. QUARTERLY TAX RETURN FILING

A. Use of Form 941 versus Form 941E

Anyone who has an employment tax liability is required to report their liability and deposits for the preceding quarter by filing either a Form 941 or Form 941E. If a payor or plan administrator is reporting only federal income tax withholdings, they may use Form 941E. A Form 941 is required if the payor or plan administrator has any wages which are fully taxable under Social Security that need to be reported. It is, therefore, unlikely that any payor or plan administrator who elects one of the alternative filing methods, which aggregates qualified plan distribution withholdings with wage withholdings, can use Form 941E.

One of the advantages of Form 941E is that it allows payors and plan administrators who do not have withholdings to report every quarter to file as an "Intermittent Filer". This allows the plan to file a 941E only for those quarters in which withholding occurs. It is imperative that the "Intermittent Filer" box be checked on each and every 941E that is filed for as long as the intermittent withholding pattern exists. Failure to check the intermittent box will result in the IRS expecting a return to be filed each quarter, and correspondence and potential penalties in a quarter when one is not received. The "Intermittent Filer" box is located on the top of the Form 941E, just before Line 1.

If a plan administrator or payor chooses to report qualified plan distribution withholdings along with other wage withholdings and taxes on Form 941, it is important that only the amount of tax withholdings from distributions be reported on Line 3. The gross amount of plan distributions is not included with wages subject to withholding on Line 2.

B. Penalties

For each whole or part of a month, for which either a Form 941 or Form 941E is not filed when required, there is a penalty of 5 percent of the amount that should have been shown on that return, up to a maximum penalty of 25 percent. In addition, for each whole or part of a month for which the taxes due are paid late, a penalty of 5 percent of the amount of tax generally applies up to a maximum penalty of 25

percent. Penalties will not be assessed in those cases where reasonable cause can be shown for the failure to file or pay the taxes due.

If a payor or plan administrator fails to withhold income taxes or fails to pay those amounts to the IRS then a 100 percent penalty may apply. The penalty is 100 percent of the income taxes not withheld or unpaid. The 100 percent penalty may be imposed on all persons who are determined by the IRS to be responsible for collecting, accounting for, and paying over these taxes, and who acted willfully in not doing so.

V. FORM 1099-R REPORTING REQUIREMENTS

A. Types of Benefit Distributions

Form 1099-R must be filed for distributions from pensions, annuities, retirement, or profit sharing plans as well as IRAs and SEPs. Disability payments made from a retirement plan should also be reported in this method. Death benefits paid outside of a pension or profit sharing plan, as well as those paid from a qualified plan, are reported on a 1099-R. Prior to 1991, partial distributions and annuity payouts were reported on Form W2-P. This form has been consolidated with Form 1099-R, which is now the sole method of reporting benefit payments.

B. Taxable versus Nontaxable Distributions

There are a number of situations which may give rise to a portion of, or all of, a distribution being nontaxable. A 1099-R is still used to report the entire distribution, and certain boxes and codes are used to identify the taxable and nontaxable portions. Nontaxable distributions can arise from: contributions made to the plan on an after-tax basis by the employee; contributions made by the employer, but characterized as by the employee under Code Section 72(f); the accumulated prior PS 58 costs for life insurance provided in a plan; and the premiums paid for non-qualified annuities.

Beginning in 1993, any distribution made in the form of a direct rollover will be reported as a nontaxable distribution using the appropriate code.

C. New Codes

Beginning in 1993, the following new codes have been added to disclose new types of distribution forms:

1. **Code E** - Excess annual additions under code section 415.
2. **Code F** - Charitable gift annuity.
3. **Code G** - Direct rollover to an IRA.
4. **Code H** - Direct rollover to a qualified plan or tax sheltered annuity.

D. Timing of Reports

The recipient of a 1099-R must receive their copy by January 31 of the year following the distribution. The IRS must receive their copies, along with a Form 1096, by the last day in February of the year following distributions.

E. Penalties

The penalty for failure to file Form 1099-R on time is \$25 per day, with a maximum penalty of \$15,000 per year. The penalty can be reduced or waived if the plan administrator or payor can demonstrate reasonable cause for the failure.

A plan administrator or payor can also incur penalties if they fail to keep adequate records required under the regulations at section 6047(c) for reporting pension or annuity payments which are subject to withholding. They can be penalized for each calendar year in which the records are not kept. The penalty for any calendar year will be \$50 times the number of individuals with respect to whom such a failure occurs during the year. However, in no case shall the maximum penalty for any taxpayer exceed \$50,000 in any calendar year.

VI. SUMMARY

For qualified plans which have made elective withholdings from their distributions in the past, the change to mandatory withholding should potentially mean only an increase in the amount of withholding. The withholding systems which these plans have in place will most likely need only modification for the new deposit timing rules. However, for many other plans whose participants have declined withholding in the past, a whole new set of administrative procedures will need to be implemented. This guide is intended to present the major framework of withholding, depositing, and reporting withheld income taxes under the new 20 percent mandatory withholding law. The reader is referred to the following sources for more detailed information regarding mandatory withholding from qualified plan distributions, and depositing and for reporting those withholdings:

1. Temporary and proposed regulations under sections 401(a)(31), 402(c), 402(f), 403(b), and 3405(c) concerning direct rollovers and mandatory withholding.
2. Treasury Regulations section 35.3405-1, "Questions and answers relating to withholding on pensions, annuities, and certain other deferred income."
3. IRS Announcement 84-40 regarding alternatives for tax administration of qualified plan withholdings. (1984-17 I.R.B. 31)
4. New final regulations under section 31.6302-0, "Deposit of Employment Taxes."
5. Instructions to Form 941 and Form 941E.
6. IRS Circular E, Employer's Tax Guide.

